United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-4227

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

SCHUSTER EXPRESS, INC.,

Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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I

STATEMENT OF LEGAL ISSUES

Schuster Express, Inc. (Taxpayer) is a motor freight common carrier with its principal corporate headquarters located in Colchester, Connecticut. As indicated in Article II hereof, taxpayer deducted, as insurance expenses, estimated amounts which far exceeded actual disbursements for such items during fiscal years ending June, 1966 through June, 1968. During the next two years, ending June, 1969 and June, 1970, taxpayer deducted loss and damage claim expenses on an estimated basis and, again, each year the deductions were substantially in excess of actual disbursements.

The Commissioner, in audit, had only the years 1968, 1969, and 1970 open to him for adjustments. In 1966 and 1967, years closed by the statute of limitations, taxpayer accumulated $73,020.00 in excess deductions. Unable to correct what it believed to be erroneous deductions in those closed years, the Commissioner claimed at trial that his disallowance of deductions in 1968, 1969, and 1970 constituted "a change in taxpayer's method of accounting" and that Section 481 is applicable to correct the erroneous deductions taken in the closed years.

In order for the Commissioner to prevail in correcting deductions taken in closed years through the use of Section 481 in this case, he must establish the following three elements:

i. The deduction, by taxpayer, of improper amounts in 1966 and 1967 constituted a "method of accounting."

ii. The Commissioner's disallowance in years 1968, 1969 and 1970 of deductions for losses and expenses in excess of actual cash disbursements constituted a "change in method of accounting."

iii. $73,020 is the amount of adjustment necessary to eliminate duplication which could arise solely by reason of the change.

The Tax Court held that taxpayer's improper and excessive deductions in 1966 and 1967 did not constitute a "method of accounting." Moreover, the Court held that these deductions were erroneous when taken, and income was being omitted because of such errors, and not "solely by reason of" the Commissioner's requirement that expenses be deducted only as cash was disbursed. The Tax Court affirmatively determined that the Commissioner had not substantiated his claim that $73,020 was the amount of the required adjustment even if his position that there was a change in accounting method was accepted.

Therefore, three issues of law are presented to this Court, each addressed sequentially herein.

1. Did the Tax Court err in finding that the deduction by taxpayer of erroneous amounts did not constitute a "method of accounting"?

2. Did the Tax Court err in finding that, even if there was a change in accounting method, $73,020.00 was not proved to be the adjustment necessary, solely by reason of the change in method, to avoid duplication of amounts?

3. Did the Commissioner actually "change" any method of accounting?

A negative response to any of the above three issues requires a holding for taxpayer.

II

STATEMENT OF THE CASE

This case is an appeal by the Commissioner of Internal Revenue Service from a decision by the United States Tax Court (per Judge Goffe), refusing to include in the taxable income of Schuster Express, Inc. for the taxable year ending June 30, 1968, the amount of $73,020. The findings of fact and opinion of the Tax Court which were filed on June 24, 1976, are reported at 66 T.C. 588. (R 94-114).[1] The decision of the Tax Court was entered, pursuant to a Rule 155 computation, on September 9, 1976 (R.115). The Commissioner filed a timely notice of appeal on December 7, 1976. (R.2). The jurisdiction of this court was invoked under Section 7482 of the Internal Revenue Code 1954.

The facts, as found by the Tax Court and as shown by the record are described in Appellants Brief on appeal before this court on pages 3 through 6 thereof, and are incorporated by reference herein.

[1]Reference to the record as transferred on appeal shall be made as "R.".

III

Section 481 is inapplicable: Taxpayer's erroneous deductions did not constitute a "method of accounting."

The threshold requirement for Section 481 to be applicable is that a "method of accounting" be changed. There has been, to date, much writing on what constitutes a method of accounting. The most comprehensive definition may be found in Interstate Fire Insurance v. I.R.S., 215, F. Supp. 586 (E.D. Tenn., 1963), aff'd 339 F.2d 603 (6th Cir. 1964):

> Upon consideration of the context in which the phrase is used in the Internal Revenue Code, in Treasury Department Regulations, and in consideration of the manner in which the phrase is applied in the decisions, it appears that the phrase "method of accounting"referred to in Section 446(a) of the Internal Revenue Code, refers to a system of accounting which, while it may result in the reflection of items sooner or later for purposes of taxation than another system of accounting, nevertheless, if consistently followed over a period of time, would correctly and truly reflect the facts with regard to the taxpayer's taxable income in accordance with the income tax laws. In other words, a "method of accounting" is a system of accounting that may alter the time at which an item or items may appear or may be utilized in calculating taxable income, and may thereby alter the tax consequences either by advancing or deferring the date upon which such items become of tax significance.

A "method of accounting," is, therefore, a system of computing income which, when adhered to consistently and continuously, will accurately reflect income. Since any method will eventually reflect income accurately a change in a method of accounting only effects the time at which the income is reflected:

> A change in method of accounting includes a change in the overall plan of accounting...or a change in the treatment of any material item used in such overall plan...A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Regs. Section 1.446-1(e).

Therefore, while a method of accounting includes any system which eventually will result in a complete and accurate reflection of income, the arbitrary or inconsistent or erroneous inclusion or exclusion of items from income does not constitute a method of accounting. See W.A. Holt Co. Inc. v. U.S., 368 F2d. 311 (5th Cir. 1966); U.S. v. Catto, 223 F. Supp. 663 (W.D. Texas 1963), aff'd 344 F 2nd 225 (5th Cir., 1965), Rev'd. on other grounds 384 U.S. 102 (1966); Interstate Fire Insurance v. I.R.S., supra; Korn Industries Inc. v. U.S., 532 F 2nd 1352 (C.Cl. 1976), and Walter H. Potter, (44 T.C. 159, 1965).

Examples of erroneous deductions, the taking of which do not constitute a "method of accounting", include the following: Erroneously understating opening inventory (Korn Industries); deducting as bad debts items which are, in fact, collectible (Holt); the deduction of monies paid as bribes; or the deduction of amounts paid in excess of "reasonable compensation."

The cases have, therefore, drawn the necessary distinction between a consistent, if ill-timed practice, and improper and arbitrary practices. Section 481 is not applicable in the latter cases.

> ...(W)hatever the method of accounting used by petitioners, there were inconsistencies in its application and...the correction of those inconsistencies does not constitute a change of accounting method...We find...that the inconsistent application of such method results in an improper reflection of income; and that respondent did not change petitioner's method of accounting for the purposes of Section 446, but merely corrected certain errors in his method which were resulting in the exclusion from gross receipts of certain amounts which should have been included therein. Potter, supra at 162.

As indicated previously, the regulations define a method of accounting as relating to the "proper time for the inclusion of the item in income or the taking of a deduction." Taxpayer's practice of deducting estimated losses without making adjustments to reflect actual losses fails to be a "method of accounting." The Tax Court found, as a factual matter, that "the deductions claimed for insurance expenses in excess of actual expenditures do not appear to properly belong in any taxable period. Thus, we do not have before us a case involving the proper time for the taking of a deduction." Therefore, just as deducting bribe payments does not relate to the proper timing of such deductions, the deduction of flat percentages of revenue as the amount of insurance expenses does not relate to proper timing.

The Commissioner's brief relies on taxpayer's use of a reserve account as evidencing a practice through which variations in estimates and actual disbursements will ultimately reconcile. Such a supposition is without support in the record. To the contrary, the Tax Court found as a

factual matter, that no such reconciliations were contemplated or possible under taxpayer's practice.

The statute of limitations prevents the Commissioner from making adjustments to returns covering closed years. The statute is specifically aimed at precluding the review of errors made in closed years. Section 481 is not available to correct errors made in closed years. "Section 481, therefore, does not hold the taxpayer to any income which he has any reason to believe he has avoided, and does not frustrate the policy that men should be able, after a certain time, to be confident that past wrongs are set at rest." Graff Chevrolet Company v. Campbell, 343 F 2nd 568, 572, (5th Cir. 1965).

To reiterate, then, a method of accounting is only a practice which will eventually properly reflect taxpayer's lifetime income. At most, a method of accounting may postpone the reporting of income. Section 481 is not directed at those accounting practices which totally avoid the reporting of income. Here, taxpayer took deductions that were erroneous; lifetime income was not ever to be properly reflected. A method of accounting is therefore not involved. The statute of limitations closes from review the years in which erroneous deductions were taken. Korn Industries Inc. v. U.S. at 1356.

IV

Section 481 is inapplicable; the Commissioner has failed to prove that a duplication of $73,020.00 of deductions would result solely by reason of a change in the method of accounting.

The Commissioner bears the burden of proof in the present case. Thus to prevail, he must affirmatively establish not only that taxpayer changed its method of accounting, but that his desired adjustment of $73,020.00 is the amount of adjustment "necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted."

The Commissioner claims that in the absence of the application of Section 481, taxpayer would be permitted to duplicate deductions; he claims that $73,020 of excess deductions were originally taken in 1966 and 1967 for items that were expected to accrue in the future, and that the change to a cash disbursement practice would result in these same items again giving rise to deductions, in the amount of $73,020, when the losses were liquidated. His conclusion is that $73,020 is the required adjustment amount. The Commissioner's claim in this regard is based upon assumptions and unsupported premises.

The record does not indicate that the expenses deducted in 1966 and 1967 in excess of cash disbursements anticipated some determinable amount of future cash disbursements. The record does not indicate the extent to which any of the

post-1967 disbursements related to operations of the prior periods. Clearly, there are no duplications of any nature if all post-1967 disbursements related to business operations of post-1967 periods. Duplications can arise only as to those post-1967 cash disbursements that are made for expenses and losses accruing out of 1966 or 1967 operations. There is no logical necessity that any amount deducted after the change in accounting practice is duplicative of any amount deducted in the 1966-1967 years.

The Commissioner bears the burden of establishing an adjustment amount which conforms to the statutory requirements. Despite his complete failure to bear this burden by introducing evidence of possible duplication as to any part of the $73,020, he has contended that the entire amount would be duplicated. His appeal, therefore, not only lacks legal basis, but does not present any factual basis for review.

The Tax Court proceeded, however, beyond the Commissioner's threshhold failure to present evidence in support of his position, and found, as a factual matter, that no part of the $73,020 would be duplicated solely by reason of the change.

> The duplication which respondent (Commissioner) seeks to reach under Section 481, the balance of the insurance reserve account as of June 30, 1967, was not caused 'solely by reason of the change.' Petitioner's total income would have been distorted by the improper deductions even in absence of the change because of the failure

> of such 'method' to account for the excessive deductions in future years. Thus, the requisite relationship between the 'duplications' and the change in method of accounting is not present.

The Tax Court's factual finding that no duplications or omissions will result solely by reason of the change is not reversable unless found to be "clearly erroneous" and not supported by the evidence. Wright-Bernet, Inc. v Commissioner, 172 F2d 343 (6th Cir., 1949), et. al. Here the Tax Court must be upheld; the Commissioner has failed to introduce any facts that would indicate the extent to which future disbursements, by reason of the change, necessarily duplicate past deductions. Clearly, in the absence of any facts in the record to the contrary, the Tax Court's findings of fact must be sustained. A key requirement of Section 481 is absent; duplications would not arise solely as a result of a change in accounting method.

V

Section 481 is inapplicable: Even assuming the existence of a method of accounting, no "change" occurred; All corrections were audit adjustments.

The Commissioner first made reference to Section 481, as the basis for audit adjustments, at trial before the Tax Court. Prior thereto, no mention had been made of a change in accounting method as the basis for corrections. The ninety day letter issued by the Commissioner made no such reference. In brief before this Court the Commissioner now argues that "taxpayer's change of accounting method in this case was a change from a reserve method...to an actual expenditures method..." Apart from the false impression conveyed thereby that a change occurred at taxpayer's initiation, the statement ignores the fact that in the entire pretrial record hereof there is no reference to any changes in accounting method. Thus taxpayer was not only deprived of the benefits of notice, but it was also deprived of its statutory right to make computation and adjustment elections under Section 481(b)(1) and Section 481(b)(2). Absent any communication or notice requirement, these latter alternatives become meaningless. If the Commissioner is to make a determination to change a method of accounting, he must be put to an obligation to affirmatively make such change. It would be inappropriate to leave taxpayers to their own deliberation and speculation as to when and if a change of accounting method occurred. See Internal Revenue Manual 4464.25, 4460-2.

Moreover, the historical record of the instant case, and the facts presented herein, indicate corrections made in audit may be characterized solely as audit adjustments. Taxpaper took deductions in excess of permissable levels. Adjustments were properly imposed for those years open to audit. Beyond such years, no corrections may be made.

VI

CONCLUSION

For the reasons stated herein, the decision of the Tax Court should be affirmed. Section 481 of the Internal Revenue Code is wholly inapplicable given the facts of the present case. Moreover, even given application of Section 481, the Commissioner has failed to meet his burden of proving that $73,020 must, in accordance with that Section, be added to taxpayer's 1968 income.

Respectfully submitted,

SCHUSTER EXPRESS, INC.

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CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this eleventh day of May, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

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